Petition

81-1295

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No. .....

IN THE

Supreme Court of the United States

October Term, 1981

SHEARSON HAYDEN STONE, INC., J. BARRY GRAY,
Petitioners,

vs.

ROBERT W. HOPE, K. JAMES POND,
Respondents,

SUPERIOR COURT OF THE COUNTY OF SANTA CLARA,
Respondent.

PETITION FOR CERTIORARI.

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Questions Presented.

A. Must the arbitration requirements contained in the RE-1 application for employment between national brokerage firms and prospective employees be validated pursuant to Federal substantive law and/or the Federal Arbitration Act, 9 U.S.C. Section 1 *et seq.*, as a contract affecting interstate commerce?

B. Do the policies and procedures of the Securities and Exchange Commission constitute federal law which preempts the courts of the State of California from invalidating the provisions of the RE-1 Agreement as an unconscionable contract of adhesion? Specifically, should the decision of this Court in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware* (1973) 414 U.S. 117, 38 L.Ed.2d 348, 94 S.Ct. 383 be reconsidered, given the 1975 amendments in the Securities and Exchange Act of 1934, 15 U.S.C. Section 78 *et seq.*, as well as regulations promulgated thereunder?

C. Can state common law defenses bar the uniform application of the Federal Arbitration Act to parties such as Robert W. Hope and K. James Pond, both of whom knowingly signed contracts agreeing to arbitrate disputes with their employer, Shearson Hayden Stone, Inc.?

D. Should the Supreme Court resolve the substantial conflict now existing between the various circuits and states concerning the application of the Federal Arbitration Act and the arbitration requirements of the New York Stock Exchange?

The Parties.

The parties to this action are Shearson Hayden Stone, Inc. ("Shearson"), and J. Barry Gray ("Gray"), Petitioners, and Robert W. Hope ("Hope"), and K. James Pond ("Pond"), Respondents. Insofar as it is an order of the Superior Court of the County of Santa Clara (the "Superior Court"), which is at issue, the Superior Court is also technically a Respondent, although it will neither appear nor assume a position with regard to this Petition.

For the Court's information, Shearson Hayden Stone, Inc., has, following the inception of this litigation, merged with American Express Company, and is now known as "Shearson/American Express, Inc."

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Respondents,

SUPERIOR COURT OF THE COUNTY OF SANTA CLARA,

Respondent.

PETITION FOR CERTIORARI.

I.
OFFICIAL AND UNOFFICIAL REPORTS.

The only opinion in this litigation which has been reported is the opinion of the Court of Appeal of the State of California, First Appellate District, Division One. (A copy of the opinion of the Court of Appeal is attached to the Appendix, labeled Exhibit "5", and incorporated herein by this reference.) The unofficial citation to that opinion is *Hope v. Superior Court of Santa Clara County* (1981) 175 Cal.Rptr. 851. As of the filing of this Petition, no official citation has been assigned to the opinion.

II.
JURISDICTION.

This Petition arises from the denial of a Petition for Hearing by the Supreme Court of the State of California, dated October 14, 1981. A copy of a letter from the Clerk of the California Supreme Court notifying Petitioners of the denial of their petition is attached to the Appendix, labeled Exhibit "6", and incorporated herein by this reference.

The jurisdiction of this Court is invoked pursuant to 28 U.S.C. §1257(c).

III.
CONSTITUTIONAL PROVISIONS, STATUTES AND RULES.

The constitutional provisions, statutes and rules cited below are pertinent to the resolution of the issues raised in this Petition. Certain of the provisions are quoted verbatim within the context of this Petition. Where the text of any citation is lengthy, the citation will be provided at this point, with the complete text of the cited material being attached to a subsequent appendix.

A. Constitutional Provisions.

1. *Article VI, United States Constitution.*

> "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

2. *Article I, Section 8, United States Constitution.*

> "The Congress shall have the Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

B. Statutes.

1. *Federal Arbitration Act*, 9 U.S.C. Section 1 *et seq.*, and incorporated herein by this reference.

2. *Federal Securities Act of 1934*, 15 U.S.C. §§78f and 78s.

3. *California Code of Civil Procedure*, Sections 1280-1294.2 ("California Arbitration Act").

4. Senate Report No. 95-75, 94th Congress, First Session, 1975, U.S. Code Congressional and Administrative News, pp. 179-182, 200-208, 306-310. (The portions of the Senate Report cited above will be attached to a subsequent appendix, with the report being incorporated herein by this reference. This Report sets forth the nature and effect of the 1975 amendments to the Securities Act of 1934.)

C. Rules.

Rules of Arbitration, New York Stock Exchange.

(The complete text of the Rules of Arbitration will be attached to a subsequent appendix, with the rules being incorporated herein by this reference).

IV.
STATEMENT OF THE CASE.

A. Procedural History.

This Petition originates from a motion by Shearson and Gray to stay proceedings before the Superior Court, and to compel arbitration. The petition to compel and motion to stay were heard on June 6, 1979 and granted on July 10, 1979. (A copy of the order of the Superior Court compelling arbitration is attached to the Appendix, labeled Exhibit "1", and incorporated herein by this reference.)

Thereafter, on or about December 10, 1979, Hope and Pond sought a writ of mandate before the Court of Appeal for the State of California, First Appellate District, Division

One. The Court of Appeal on or about December 11, 1979, denied the petition of Hope and Pond with regard to Shearson, stating that the Superior Court did not err in compelling arbitration against Shearson. A peremptory writ of mandate was issued as to Gray, however, with the court stating that inasmuch as Gray was not a party to the arbitration agreement, he could not compel arbitration. The granting of the writ as to Gray is not before this Court. (A copy of the order of the Court of Appeal denying the writ as to Shearson is attached to the Appendix, labeled Exhibit "2", and incorporated herein by this reference.)

Following the Order of the Court of Appeal denying Hope and Pond's petition for writ of mandate as to Shearson, Hope and Pond filed a petition for writ of mandate before the Supreme Court of the State of California, which petition was filed on or about January 14, 1980. On or about April 9, 1980, the California Supreme Court granted a petition for hearing, thereby transferring the cause to the jurisdiction of the Supreme Court of the State of California. (A copy of the order granting the petition for hearing is attached to the Appendix, labeled Exhibit "3", and incorporated herein by this reference.)

The California Supreme Court thereby ordered that an alternative writ was to be issued, served and filed on or before March 26, 1980, with a written return to be served and filed on or before April 11, 1980.

Following the granting of a hearing by the California Supreme Court, this matter was retransferred, on or about March 11, 1981, to the Court of Appeal, First District, Division One, for oral argument, reconsideration and determination in light of *Graham v. Scissor-Tail* (1981) 28 Cal.3d 807, 171 Cal.Rptr. 604, a recent California Supreme Court decision involving some of the same issues contained within this Petition. (A copy of the order retransferring the

matter to the Court of Appeal is attached to the Appendix, labeled Exhibit "4", and incorporated herein by this reference.) The matter was then briefed and argued before the Court of Appeal, with the Court of Appeal rendering its decision on or about July 29, 1981.

Following the decision of the Court of Appeal, Shearson filed a petition for hearing before the California Supreme Court, on or about September 4, 1981. On or about October 14, 1981, the Clerk of the California Supreme Court advised Shearson that its petition had been denied.

B. Statement of Facts.

The complaint in this matter, filed on or about May 2, 1979, seeks to plead causes of action for breach of contract arising out of the employment of Hope and Pond as account executives with Shearson, as well as for interference with business relationships and unfair competition arising out of their termination of employment with Shearson.

Factually, the complaint alleges that Shearson failed to pay certain commissions due to Hope and Pond on termination, that Shearson interfered with respondents' obtaining of subsequent employment and that Shearson failed to transfer customers' accounts to respondents' new brokerage firm following respondents' resignation. These allegations are made despite the fact that within two days following their resignation from Shearson, Hope and Pond obtained similar positions with a competitor brokerage firm.

On or about April 12, 1972, and February 5, 1969, respectively, Hope and Pond executed written RE-1 Applications for Approval of Employment (the "RE-1 Agreement") with Shearson's predecessor, Shearson, Hammil & Co. Paragraph 31(j) of the Agreement specifically provides for arbitration of the types of controversies raised by

Hope and Pond in their complaint. Paragraph 31(j) provides as follows:

> "31(j) I agree that any controversy between me and any member or member organization or affiliate or subsidiary thereof arising out of my employment or the termination of my employment shall be settled by arbitration at the instance of any such party in accordance with the arbitration procedure prescribed in the Constitution and rules then obtaining of the New York Stock Exchange."

In addition to agreeing to be bound by the language quoted above, Hope and Pond further executed arbitration agreements with Shearson upon being licensed by the American Stock Exchange, which agreements provide in pertinent part as follows:

> "30(10) I agree that any controversy between me and any member or member organization of the American Stock Exchange arising out of my employment by and with such member or member organizations or any successor thereto shall be settled by arbitration at the instance of any such party in accordance with the Constitution and rules then obtaining of the American Stock Exchange or, if the employer be a member or member organization of the New York Stock Exchange, in accordance with the Constitution and rules of that Exchange."

Finally, in addition to executing the RE-1 Agreements, both Hope and Pond further agreed to comply with all of the rules of the various associations and exchanges to which they belonged, including the National Association of Securities Dealers (N.A.S.D.), Chicago Board of Options Exchange, and/or Pacific Stock Exchange. The Code of Arbitration of each of those entities contains a provision whereby the broker agrees to arbitrate disputes arising out of his employment relationship. The language of the Code

of Arbitration of the N.A.S.D. is representative, at Section 2(a)5:

> "Any dispute, claim, or controversy subject to arbitration under the code . . . shall be submitted to arbitration pursuant to this Code at the instance of . . . (5) a member against a person associated with a member or a person associated with a member against a member."

Despite executing documents, the terms of which require that Hope and Pond arbitrate controversies arising out of their employment or termination of employment, Hope and Pond now contend that they should not be required to arbitrate their disputes. Shearson submits that both the agreements and the consent of Hope and Pond thereto are valid and binding, and that each and every cause of action contained within respondents' complaint must be resolved under the Rules of Arbitration of the New York Stock Exchange.

C. Review of Federal Questions.

As Shearson's original petition to compel arbitration and motion to stay proceedings were granted by the Superior Court on the basis of its reading of the California Arbitration Act, no reference to the federal issues involved within this case was necessary or appropriate. In its second pleading, entitled "Return by Real Parties in Interest to Petition for Writ of Mandate," however, Petitioners made explicit reference at page 15 to the case of *Drayer v. Krasner* (2nd Cir. 1978) 578 F.2d 348, *cert. den.*, 436 U.S. 948, thereby raising both preemption and commerce clause arguments based upon the "flow of business on securities exchanges" and the issue of self-regulation by the Securities and Exchange Commission. (Complete copies of all pleadings previously filed by Petitioner will be filed with this Court at a later date.)

In denying Hope and Pond's petition for writ of mandate, no mention was made by the California Court of Appeal with regard to potential federal issues involved in this litigation.

Hope and Pond then filed a petition for writ of mandate before the California Supreme Court. In response to this petition, Shearson filed its third and fourth pleadings, both with the Supreme Court, entitled "Return by Real Parties in Interest to Petition for Alternative Writ of Mandate" and "Supplemental Brief and Application by Real Parties in Interest to File Supplemental Points and Authorities."

The document entitled "Return by Real Parties in Interest" at pages 18-19, raises arguments identical to those raised in Shearson's "Return" filed before the Court of Appeal.

The document entitled "Supplemental Brief and Application by Real Parties in Interest to File Supplemental Points and Authorities", Shearson's fourth brief at page seven, discusses the activities by the New York Stock Exchange and the Securities and Exchange Commission relating to the revision of arbitration rules pursuant to Section 19(b) of the Securities and Exchange Act of 1934. These arguments set forth the foundation for Shearson's preemption or supremacy claim, and, in view of the licensing and registration provisions, also relate centrally to Shearson's commerce clause and/or Federal Arbitration Act arguments.

The California Supreme Court then retransferred the matter to the Court of Appeal, at which time further briefing was requested with regard to a recent California Supreme Court decision entitled *Graham v. Scissor-Tail* (1981) 28 Cal.3d 807, which involved certain of the issues raised in this appeal.

Even though Shearson's fifth brief, as requested, directed itself principally to an analysis of *Graham v. Scissor-Tail*, Shearson, once again, at page six of that brief raised the issues of preemption, supremacy and/or the effect upon the commerce clause by virtue of its citation to the amendment and regulation of the Rules of Arbitration by the Securities and Exchange Commission and the New York Stock Exchange.

The Court of Appeal, in ruling against Shearson in its opinion dated July 29, 1981, also failed to address the federal issue raised by Shearson. Therefore, Shearson in its Petition for Hearing filed on September 4, 1981 with the Supreme Court of California set forth in detail at pages 5-12, each of the federal arguments raised in this appeal, thereby amplifying and expounding upon the doctrines relating to preemption and/or the commerce clause which had been raised at earlier stages of the appeal.

In its summary denial of petition for Hearing, the California Supreme Court did not address or discuss any of the issues raised in Shearson's petition.

V.
ARGUMENT.

A. The RE-1 Agreement, as a Contract Affecting Interstate Commerce, Must Be Validated Pursuant to Federal Substantive Law and the Commerce Clause.

The RE-1 Agreement, in creating an employment relationship which involves and affects interstate commerce, must be enforced pursuant to applicable federal substantive law. The Court of Appeal therefore erred in attempting to invalidate the arbitration provision on the grounds of unconscionability. *Main v. Merrill Lynch, Pierce, Fenner &*

Smith (1977) 67 Cal.App.3d 19, 136 Cal.Rptr. 378; *Dickstein v. DuPont* (2d Cir. 1971) 443 F.2d 283.

The case of *Main v. Merrill Lynch, Pierce, Fenner & Smith, supra,* is controlling on this issue. In *Main*, the plaintiff also attempted to avoid the effect of the arbitration provision in opposing defendants' petition to compel arbitration. The Court of Appeal, with regard to the issue of the validity of the arbitration provision, however, disagreed.

The court in *Main* noted that the Federal Arbitration Act is applicable to a "written provision in . . . a contract evidencing a transaction involving [interstate] commerce . . ." (See 9 U.S.C.A. §2). *Main v. Merrill Lynch, Pierce, Fenner & Smith, supra*, 67 Cal.App.3d at 24. Of special significance to the present case is its language at page 24 concerning the application of the Federal Arbitration Act to state court litigation:

> ". . . But it has now been widely held that the Act is equally applicable to such proceedings brought in state courts arising out of transactions involving interstate commerce, or admiralty."

Noting that federal law would therefore apply, the court in *Main* continued at page 24:

> "The Federal Arbitration Act, declaring arbitration agreement[s] affecting [interstate] commerce or maritime affairs to be valid, enforceable, and irrevocable, is a declaration of national law equally applicable in state or federal courts." (Citing numerous state and federal decisions.)

Finally, with regard to the application of the Federal Act rather than state law doctrines, the court held as follows:

> "We find this authority compelling, and hold the Arbitration Act to be applicable to California's courts in the case of a contract evidencing a transaction involving interstate commerce to settle by arbitration a contro-

versy thereafter arising out of such contract or transaction." (67 Cal.App.3d at 25.)

The rules set forth in *Main, i.e.*, that federal law controls as to the enforceability of an arbitration provision, have been confirmed in more recent appellate court decisions. *Lounge-A-Round v. GCM Mills, Inc.* (1980) 109 Cal.App.3d 197, 166 Cal.Rptr. 920; *Safeway Stores v. Brotherhood of Teamsters, etc.* (1978) 83 Cal.App.3d 430, 147 Cal.Rptr. 835. In both of these decisions, the Courts of Appeal confirm that federal law will control with regard to the enforceability of an arbitration provision affecting commerce. (See also *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Haydu* (5th Cir. 1981) 637 F.2d 391.)

In *Dickstein v. DuPont* (2nd Cir. 1971) 443 F.2d 783, the United States Court of Appeal, First Circuit, was faced with the precise issue before this Court, concerning whether or not the RE-1 contract was a contract which "affected commerce." The court's analysis of this issue was brief and direct:

> "The application was submitted jointly to the NYSE by DuPont as 'applicant' and Dickstein as 'candidate'. As a condition precedent to his employment by DuPont, the application was an integral and mutually binding part of appellant's employment arrangement with DePont. Given this conclusion, appellant's argument that the promise to arbitrate disputes was not part of a 'contract evidencing a transaction involving commerce', 9 U.S.C. Section 2, fails, *for it is clear that the creation of an employment relationship which involves commerce is a sufficient 'transaction' to fall within Section 2 of the Act.*" (443 F.2d at 783; emphasis added.)

Numerous other arbitration provisions contained within securities agreements have, in accordance with the analysis

of the Court set forth in *Dickstein v. DuPont*, quoted above, been held to be portions of contracts which "affect interstate commerce." *Arkoosh v. Dean Witter & Co., Inc.* (D.Neb. 1976) 415 F.Supp. 535; *Coenen v. R. W. Pressprich & Co.* (2d Cir. 1972) 453 F.2d 1209. In both of these cases, even the mere sale of a security was sufficient to cause the Court to conclude that the contract "affected commerce", thereby requiring arbitration under the Federal Arbitration Act.

Shearson therefore submits that, as a matter of law, the Court of Appeal below erred in attempting to invalidate the RE-1 Agreement based on a state common law doctrine of unconscionability. Pursuant to *Main v. Merrill Lynch, Pierce Fenner & Smith*, as well as additional authorities cited above, the arbitration provision contained within the RE-1 Agreement should be upheld and enforced pursuant to federal substantive law, as affecting interstate commerce.

B. The Policies and Procedures of the Securities and Exchange Commission Constitute Federal Law Which Preempts the State of California From Ruling That the Arbitration Procedures Herein Are Invalid as Originating From an Unconscionable Contract of Adhesion.

At this point, Shearson advances a separate and distinct theory based upon federal law regarding the enforceability of arbitration provisions. In addition to the points discussed above, Shearson contends that, based upon the doctrine of federal preemption, the policies and procedures of the Securities & Exchange Commission (hereinafter the "SEC") constitute federal law which preempts the State of California from ruling that the arbitration procedures herein are invalid as originating from an unconscionable contract of adhesion.

Article VI of the Constitution of the United States provides, in pertinent part, that valid federal law will supersede

inconsistent state law by making "laws of the United States . . . made in pursuance [of the Constitution] . . . the supreme law of the land." The preemption may consist of a direct statutory conflict or, as in the present case, may occur where Congress has established or adopted a comprehensive scheme of regulations over a particular subject matter. *(See generally,* L. Tribe, *American Constitutional Law,* Sections 6 through 25 (1978).) Shearson's claim focuses upon preemption by the entire regulatory authority of the SEC.

Where the comprehensive regulatory authority appears, state law in that field may be displaced even in the absence of a directly conflicting federal statute. Although the Supreme Court, itself, in *Florida Lime and Avocado Growers v. Paul* (1963) 373 U.S. 132, 10 L.Ed.2d 248, 83 S.Ct. 1210, stated that the preemptive power was not to be presumed absent persuasive reasons, Shearson submits that the regulatory enactments adopted and approved by the SEC pursuant to Congressional authority contained within Section 19 of the Securities Exchange Act of 1934 (hereinafter the "Act") confirm that in the area of arbitration of securities-related disputes, Congress has "unmistakenly ordained" the necessity for preemption. *(Florida Lime and Avocado Growers v. Paul, supra.)*

The United States Congress has established, pursuant to Section 19 of the Act (15 U.S.C. §78s), that the SEC is authorized to institute such procedures as are necessary not only for the protection of investors in the Exchange, but also to ensure the fair and efficient resolution of disputes involving securities-related matters. Shearson submits that the order of the Court of Appeal in denying enforcement of the arbitration provision approved and adopted by the SEC has the effect of thereby thwarting and abrogating the right of the SEC to effect an efficient implementation of the procedures utilized in the securities industry.

Shearson acknowledges that a similar preemption claim was advanced before the United States Supreme Court in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware* (1973) 414 U.S. 117, 38 L.Ed.2d 348, 94 S.Ct. 383, and that under the facts of that case the claim was rejected. However, due to various amendments in the Act as well as the Rules of Arbitration of the New York Stock Exchange following the *Ware* decision, the Congress has indicated, through the SEC, that at least with regard to the arbitration of securities-related disputes, the supervisory authority of the SEC preempts state common law doctrines of unconscionability.

In the *Ware* opinion, Merrill Lynch argued that state law concerning arbitration involving Exchange members must be preempted, in order to avoid the undermining of investor confidence in the Exchange's operations. The Supreme Court rejected this argument, nothing that under the (then) limited authority of the Commission to supervise the protection of the investors, the link between compulsory arbitration and the purpose of the Act was too attenuated to justify preempting state law.

The supervisory authority of the SEC was, however, amended and enlarged in 1975, at which time Congress indicated that the goals of the Act were not only to protect investor confidence, but also to foster competition and efficiency in the Exchange markets. (See S.Rep.No. 94-75, 94th Congress, First Session, 1975, U.S. Code Cong. and Admin. News 179, 182 (hereafter "1975 C. & A.N.").) Therefore, to the extent that the arbitration procedures of the New York Stock Exchange constitute a more efficient mechanism in the operation of the Exchange, the preemption of state law, especially state common law, is required.

Not only were the goals of the Act broadened in the 1975 amendment, but the SEC's supervisory authority was extended. As the Supreme Court in *Ware* noted, former Sec-

tion 19(b) of the Act limited the Commission's authority to scrutinize New York Stock Exchange Rules to 12 designated subject areas, none of which included employer-employee arbitration rules. *Ware, supra,* 414 U.S. at 129. The 1975 amendments, however, eliminated the subject area limitation on the Commission's authority (1975 C. & A.N. 205-06), thereby transferring the authority to create and approve arbitration rules to the jurisdiction of the SEC.

A third factor distinguishes the present case from the holding of the Supreme Court in the earlier *Ware* opinion. Whereas the United States Supreme Court indicated at the time of *Ware* that "the SEC has exercised its direct supervisory power sparingly", 414 U.S. at 129-30, *supra*, the same assertion is no longer true today. One of the major purposes of the 1975 amendments was to cause the SEC to become more active in overseeing the regulation of the Exchanges. In this regard, the SEC was expressly directed to review existing and proposed Exchange rules to assure their compliance with the Act, and, specifically, the recently acquired purpose of fostering efficiency and competition. (1975 C. & A.N., 206, 307.)

In addition, for the first time, the SEC was given express authority to initiate changes in the Exchange rules. (1975 C. & A.N., 206, 308.) This point was recognized by the United States Supreme Court in *Gordon v. New York Stock Exchange, Inc.* (1975) 422 U.S. 659, 45 L.Ed.2d 463, 95 S.Ct. 2598, wherein the Court stated that "the new legislation amends Section 19(b) of the Act to substitute for the heretofore existing provision a procedure for SEC review of proposed rules and rule changes of the various self-regulating organizations."

The amendments relating to the arbitration provision were lauded by the United States Court of Appeals, Second District in *Coenen v. R. W. Pressprich & Co.* (2d Cir. 1972)

453 F.2d 1209, 1214, as being, ". . . precisely the kind of self-regulatory provision called for by the 1934 Act." It is also significant to note that in its supervisory authority to review and approve the rules of the various exchanges, the SEC has not chosen to disapprove the Exchange's rules, as amended.

An excellent discussion of the preemption issue as it relates to the arbitration of securities-related disputes appears in the recent and similar case of *Drayer v. Krasner* (2d Cir. 1978) 578 F.2d 348, *cert. den.* 436 U.S. 948. In *Drayer*, a predecessor of Shearson sought arbitration under circumstances almost identical to the present case. Similar to the present challenges made by Hope and Pond, the employee in the *Drayer* case challenged not only the validity of the arbitration requirement *per se*, but also the composition of the arbitration tribunal, alleging that the arbitration procedures were unfair.

The Second Circuit, however, speaking through Justice Friendly, rejected plaintiff's argument, and affirmed the order of the trial court compelling arbitration. In so holding, Judge Friendly discussed the 1975 amendments to the Act, and concluded that the Commission's failure to disapprove the New York Stock Exchange rules was sufficient to immunize the rules from plaintiff's attack. In so holding, the court distinguished *Ware*, by noting that the arbitration rules now fall within the SEC's expanded authority and concluded that:

> ". . . Whatever the relationship of this rule to the objective of investor protection, it is germane to the goal of market efficiency, reflected in Section 6(b) [15 U.S.C. §78f] and throughout the 1975 amendments . . . and to the objective of fair administration of the Exchange, implicated in Section 6(b) and an explicit

standard of Section 19(c)." (*Drayer v. Krasner, supra,* at p. 358.)

The court thus concluded at page 358 as follows:

"It is likewise in the interest of fair administration and market efficiency, as well as in the public interest, that honest and ethical registered representatives should have speedy, cheap, and effective remedies against their employers. At least, the NYSE is entitled to think this in the absence of any indication otherwise from the SEC."

The court's opinion in *Drayer v. Krasner* is significant not only for its treatment of the preemption issue, but also because of its rejection of an attack to the fairness of the composition of the arbitration tribunal, itself. Judge Friendly defended the selection procedures presently under attack, stating that ". . . *absent evidence of actual unfairness* in the operation of NYSE arbitration tribunals, their composition [was not] so improper as to invalidate the program under the anti-trust laws." (*Drayer v. Krasner, supra,* at p. 359; emphasis added.)

Of further significance to the present Petition, the court in *Drayer* explicitly rejected the reasoning of the Court of Appeal in the present litigation, noting the following:

"The mere fact that the three members not engaged in the securities business are drawn from a panel appointed by the Chairman of NYSE does not reflect on their fairness in a dispute between a member and a registered representative; the arduous and generally thankless task of acting as an arbitrator represents rendition of a service rather than receipt of a perquisite."

Finally, the court concluded that the evidence showed that the tribunals had not been shown to be biased against non-members, and further, that the *Association of Investment Brokers,* the trade association of the registered rep-

resentatives, had *not* seen fit to complain to the SEC concerning the arbitration procedures. (*Drayer v. Krasner, supra,* at p. 359.)

Shearson submits that the preemptive effect of the Rules of Arbitration of the New York Stock Exchange encompasses not only state anti-trust laws, but also state common law doctrines of unconscionability. See also *Rust v. Drexel Firestone, Inc.* (S.D.N.Y. 1972) 352 F.Supp. 715; *Silver v. New York Stock Exchange* (1963) 373 U.S. 341, 10 L.Ed.2d 389, 83 S.Ct. 1247. Relying upon the *Silver* opinion, Judge Weinfield from the Southern District of New York states the following:

> "*Silver* held that particular instances of exchange self-regulation which fall within the scope and purposes of the Securities & Exchange Act are valid defenses to anti-trust claims. There is even more reason that the self-regulatory function of the Exchange should be honored in resisting a claim upon the nebulous common law concept of duress than in the instance of an anti-trust claim based upon federal statutory law whose enforcement is in the public interest . . . If the policies behind the Securities & Exchange Act immunize the arbitration provision as a condition of employment from anti-trust attack, then the same policies foreclose a challenge based upon the theory of duress which, unlike anti-trust, is not part of the federal statutory law." (*Rust v. Drexel Firestone, Inc.*, 352 F.Supp. at 718.)

Shearson therefore submits that the supervisory role and procedures of the SEC constitute federal law which preempts the state Court of Appeal from ruling that the arbitration procedures are invalid as resulting from an unconscionable contract of adhesion.

C. Shearson's Petition for Writ of Certiorari Should Be Granted in Order to Allow This Court to Resolve the Issues Relating to the Application of the Federal Arbitration Act in a Uniform and Equitable Manner.

As is evident from Shearson's argument under Subsection VA, *supra*, a substantial conflict now exists among and between the various states and circuits concerning the application of the Federal Arbitration Act to arbitration provisions such as the RE-1 Agreement. The California Court of Appeal has chosen, by its opinion in this litigation, to nullify the effect of this provision based upon the common law doctrine of unconscionability. Should the action be brought in the State of New York, however, that court, following *Drayer v. Krasner, supra,* 572 F.2d 348, would presumably be compelled to hold that such common law defenses would be inapplicable. Similarly, if the action is filed in the State of Massachusetts, also in the Second Circuit, the Court's holding in *Dickstein v. DuPont, supra,* 443 F.2d 283, would also be controlling in requiring that arbitration be upheld pursuant to the Federal Arbitration Act.

For the most recent confirmation of above cases from the State of Florida see also *Merrill Lynch, Pierce, Fenner & Smith, Inc., and Brian Sheen v. Helen Melamed* (1981) 4th District Court of Appeal — November 12, 1981; Florida Law Weekly, Vol. 6 at pp. 24-25. The *Melamed* opinion, decided by the Florida Court of Appeal on November 12, 1981, also involved a conflict between the Federal Arbitration Act and state law. The Court of Appeal held, without reservation, that the state courts are bound to apply the Federal Arbitration Act when it applies.

Even worse, the conflict which exists between the circuits also exists within the very State of California. As set forth above, the Court in *Main v. Merrill Lynch, Pierce, Fenner & Smith, supra*, 67 Cal.App.3d 19, holds that arbitration must be compelled, once again pursuant to the Federal Arbitration Act. The First District Division One, now holds, however, by its opinion in this litigation, that it is the state common law defense, rather than the federal arbitration legislation which must control.

Shearson submits that this Petition should be granted, in order to allow this Court to achieve a more uniform resolution of this issue between the states, between the circuits and even within the very State of California. Where, as in the present litigation, interstate commerce is so clearly affected, Shearson submits that a more uniform application of the Federal Arbitration Act must be mandated by this Court in order to arrive at an equitable result.

VI.
CONCLUSION.

For the reasons set forth above, Shearson respectfully requests that this Petition for Writ of Certiorari be granted, and that Shearson be allowed to present further legal argument to this Court in support of its contention that the ruling of the California Court of Appeal must be reversed and arbitration once again compelled in this matter.

Respectfully submitted,

KEESAL, YOUNG & LOGAN,
A Professional Corporation,
By MICHAEL M. GLESS,
ROBERT D. FEIGHNER,

Attorneys for
Shearson, Hayden Stone, Inc.
and J. Barry Gray.

Appendix

APPENDIX.

Exhibit "1"

Order of the Superior Court of Santa Clara County Granting Shearson's Petition to Compel Arbitration and to Stay Superior Court Proceedings.

In the Superior Court of the State of California, in and for the County of Santa Clara, Court convenes at SAN JOSE.

Title: Robert W. Hope, vs., Shearson Haden Stone Inc.

Date: July 10, 1979, Present: Hon Bruce F. Allen, Judge, W. Fisher, Reporter, Courtroom 2, R. Politz Deputy Clerk.

Nature of Proceedings: Matter regularly before the Court for hearing with counsel present. The matter is argued and submitted.

Whereupon the Court makes its order that the petition to arbitrate (New York Stock Exchange rules) is granted as to all counts.

ACTION NO. 425269

Exhibit "2"

Order of the California Court of Appeal Denying Hope and Pond's Petition for Writ of Mandate as to Shearson.

Court of Appeal of the State of California, in and for the, First Appellate District, Division One.

Robert W. Hope, et al., Petitioners, vs. Superior Court, County of Santa Clara, Respondent, Shearson Hayden Stone, Inc., et al., Real Parties in Interest. No. 47841, Superior Court No. 425269.

Filed December 11, 1979.

By the Court:

Petitioners, Robert Hope and K. James Pond seek a writ of mandate to compel respondent court to vacate its order compelling arbitration of their action against their former employer, real party Shearson Hayden Stone, Inc. and its employee J. Barry Gray.

We have read and considered the petition and the opposition filed. The matter has been fully briefed, with due notice to all parties, and we therefore are empowered to issue the peremptory writ in the first instance. (Code Civ. Proc., §1088.)

We are convinced that respondent court did not err in compelling arbitration against Shearson. (Code Civ. Proc., §1281.2; Frame v. Merrill, Lynch, Pierce, Fenner & Smith (1971) 20 Cal.App.3d 668, 672; Lewsadder v. Mitchum, Jones & Templeton, Inc. (1973) 36 Cal.App.3d 255, 259.)

Real party Gray, however, was not a party to the arbitration agreement. The causes of action against him may not be determined by arbitration. (Code Civ. Proc., §1281.2.) His presence in the action does not preclude arbitration. (CBCO, Inc. v. Grani Installation, Inc., (1979) 95 Cal.App.3d 290, 293.) Therefore, the action should be stayed pending

resolution of the arbitration. (Code Civ. Proc., §§1281.2(c), 1281.4.)

A peremptory writ of mandate will issue directing the trial court to vacate the order of arbitration against real party Gray and to enter an order staying petitioners' action pending resolution of the arbitration, in conformity with the views expressed herein.

Dated Dec. 11, 1979

Elkington, J. Acting P.J.

Exhibit "3"

Order of the California Supreme Court Granting a Petition for Hearing and Stating That an Alternative Writ Is to Be Issued.

Order Granting Hearing
After Judgment by the Court of Appeal
1st District, Division 1, Civil No. 47841.

In the Supreme Court of the State of California, In Bank.

Hope et al., Petitioners, v. The Superior Court of Santa Clara County, Respondent; Shearson Hayden Stone, Inc., et al., Real Parties in Interest. S.F. 24136.

Filed March 20, 1980.

Petition for hearing GRANTED and cause transferred to this court.

Let an alternative writ of mandate issue to be heard before this court when the proceeding is ordered on calendar.

The alternative writ is to be issued, served and filed on or before March 26, 1980.

The written return to the writ is to be served and filed on or before April 11, 1980.

/s/ Tobriner
Justice
Mosk
Justice
Richardson
Justice
Manuel
Justice

Received Mar. 24, 1980

Exhibit "4"

Order of the California Supreme Court Retransferring the Matter to the Court of Appeal.

In the Supreme Court of the State of California, In Bank.

Hope et al., Petitioners, v. The Superior Court of Santa Clara County, Respondent; Shearson Hayden Stone, Inc., et al., Real Parties in Interest. S.F. NO. 24136. (1st. Civil 47841).

The above entitled cause in which an alternative writ of mandamus has been issued by this court is retransferred to the Court of Appeal, First District, Division One, for oral argument, reconsideration and determination in the light of Graham v. Scissor Tail 28 Cal.3d 807.

/s/ Bird
Chief Justice

Received, Mar. 13, 1981.

Exhibit "5"
Opinion of the California Court of Appeal.

In the Court of Appeal of the State of California, First Appellate District, Division One.

Robert W. Hope, K. James Pond, Petitioners, vs. Superior Court of the County of Santa Clara, Respondent. Shearson Hayden Stone, Inc., J. Barry Gray, Real Parties in Interest. 1 Civil 47841, (Super. Ct. No. 425269).

In *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal.3d 807, the California Supreme Court established certain guidelines for determining when an arbitration agreement consititutes an unenforceable contract of adhesion. In this proceeding we are called upon to apply those guidelines to contracts of employment between a securities brokerage firm and two of its account executives, calling for settlement of a broad range of disputes through arbitration procedures prescribed in the constitution and rules of the New York Stock Exchange. We shall hold that the agreement for arbitration in this case is a contract of adhesion under applicable principles, and that the procedures for arbitration prescribed by the constitution and rules of the New York Stock Exchange are so one-sided, as applied to employer-employee disputes, as to render the agreement unenforceable.

Background.

Petitioners Robert W. Hope and K. James Pond were employed as account executives in the Palo Alto office of real party in interest Shearson Hayden Stone, Inc. (Shearson). In February 1979, they were both given the option of resigning or being terminated. They left, went to work for a competitor of Shearson's, and later sued Shearson in respondent superior court claiming that Shearson owed them more than $100,000 for commissions. They also claimed that Shearson had tortiously interfered with their advanta-

geous business relationships and engaged in unfair competition by misrepresenting their honesty and skill to Shearson's clients, by making false and derogatory comments about their abilities and experience to local brokerage firms, and by delaying or refusing to transfer accounts to their new brokerage firm.

Shearson moved to stay the proceedings (Code Civ. Proc., §1281.4) and to compel arbitration (Code Civ. Proc., §1281.2) on the basis of a provision contained in a seven-page "Application for Approval of Employment" which each petitioner had signed when he was first employed by Shearson. The application is a form (No. RE-1) supplied by the New York Stock Exchange, of which Shearson is a member. The provision reads: "I agree that any controversy between me and any member or member organization or affiliate or subsidiary thereof arising out of my employment or the termination of my employment shall be settled by arbitration at the instance of any such party in accordance with the arbitration procedure prescribed in the Constitution and rules then obtaining of the New York Stock Exchange, Inc."

The constitution of the New York Stock Exchange is a formidable document of some seventy pages. Provisions relating to arbitration are found in article VIII.[1] Under these provisions, the chairman of the board of directors of the Exchange (subject to approval by the board itself) appoints a board of arbitration composed of such number of members and allied members of the Exchange as he deems necessary, and two panels of arbitrators "composed of persons who are residents of or have their places of business in the Met-

---

[1]Article VIII, and the rules of the board of directors pertaining to arbitration, have been amended in certain relevant respects since the trial court's ruling. The parties stipulated at oral argument that the case should be decided on the basis of the current rules.

ropolitan area of the City of New York." The first panel is composed of persons engaged in the securities business, and the second of persons not so engaged. The chairman is empowered to appoint similar panels to serve outside the City of New York. In addition, he is called upon to designate one of the officers or other employees of the Exchange as arbitration director.

Controversies between a non-member and a member of the Exchange (as in the present case), unless they involve a public customer or less than $100,000, are heard and determined by five arbitrators selected by the arbitration director, at least three of whom must be from the second panel unless the non-member requests a greater number from the first panel. Such arbitration proceedings are to be held "where designated by the Exchange" and conducted "in such manner and pursuant to such rules as the Board of Directors shall from time to time adopt." Subject to rules of the board, the arbitrators determine the amount chargeable to the parties as costs, to cover the expense of the hearings.

Current rules of the board pertaining to arbitration provide that a party may peremptorily challenge one member of the arbitration panel. In addition, arbitrators are required to disclose to the director of arbitration "any circumstances which might preclude such arbitrator from rendering an objective and impartial determination," and the director is empowered to remove "an arbitrator who discloses such information." The rules contain a schedule of fees which must be deposited by a claimant with the Exchange in advance of arbitration, unless the deposit is waived by the director of arbitration. Where the amount in dispute is $100,000 and over, the amount of the required deposit is $550.

Petitioners argued to the trial court, among other things, that they never saw the relevant provisions of the Exchange's constitution and bylaws, and that in any event they should not be bound by those provisions, which were adhesive and unfair. When the trial court ordered arbitration nevertheless, petitioners sought relief through a petition for writ of mandate, filed in this court[2] and then in the Supreme Court. The Supreme Court issued an alternative writ and, after its decision in *Graham v. Scissor-Tail, Inc., supra*, 28 Cal.3d 807, transferred the case to this court for reconsideration and determination in light of that opinion.

At oral argument before this court, the parties agreed that under Labor Code section 229, as applied in *Ware v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1972) 24 Cal.App.3d 35, 43-45, affd. 414 U.S. 117, petitioners' claim against Shearson for commissions due is exempt from arbitration as a matter of state policy.[3] This leaves at issue petitioners'

---

[2]Petitioners named J. Barry Gray, an executive of Shearson, as a defendant in the underlying lawsuit, and the trial court had ordered arbitration as to Gray as well as to Shearson. This court issued a peremptory writ of mandate directing the trial court to vacate its order as to Gray, on the ground that Gray was not aparty to the arbitration agreement. The propriety of that determination is no longer an issue in this case. This court denied relief as to Shearson on the authority of *Frame v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1971) 20 Cal.App.3d 668, 672, and *Lewsadder v. Mitchum, Jones & Templeton, Inc.* (1973) 36 Cal.App.3d 255, 259.

[3]Section 229 provides: "Actions to enforce the provisions of this article for the collection of due and unpaid wages claimed by an individual may be maintained without regard to the existence of any private agreement to arbitrate. This section shall not apply to claims involving any dispute concerning the interpretation or application of any collective bargaining agreement containing such an arbitration agreement." The Court of Appeal in *Ware* determined that the intent of this provision "is to provide in the first instance a judicial forum where there exists a dispute as to wages" (24 Cal.App.3d 35, at p. 43), and thus to bar arbitration of a claim by employees of a stock brokerage firm for benefits under a profit sharing plan. That decision was affirmed by the United States Supreme Court, as against a contention by the brokerage firm that California's policy conflicted impermissibly with federal policy favoring arbitration of disputes involving the New York Stock Exchange (414 U.S. 117). The term "wages" is defined in Labor Code section 200 as including "all amounts for labor performed by employees of every description, whether the amount is fixed or ascertained by the standard of time, task, piece, *commission basis*, or other method of calculation." (Emphasis added.)

tort claims for interference with advantageous business relationships and unfair competition. Petitioners' contention that these claims are not within the scope of arbitration is without merit: The arbitration provision contained in the employment application form is broadly phrased to include "any controversy . . . arising out of my employment *or the termination of my employment*" (emphasis added), and in *Lewsadder v. Mitchum, Jones & Templeton, Inc., supra*, 36 Cal.App.3d at p. 259, an agreement whch did not contain the emphasized.language was held broad enough to include tort claims arising out of termination. We therefore proceed to consider the issues posed by the Supreme Court's transfer order.

THE SCISSOR-TAIL OPINION.

In *Graham v. Scissor-Tail, Inc., supra*, 28 Cal.3d 807, Bill Graham, promoter and producer of musical concerts, entered into a series of contracts with a group of musicians and their representatives on forms provided by the American Federation of Musicians (A.F. of M.), a labor union which included the contracting musicians as members. The forms contained several blanks, in which the parties inserted the terms of their agreement, but they also included certain printed clauses, among which was one to the effect that all controversies arising out of the agreement would be submitted to the International Executive Board of the A.F. of M., pursuant to the constitution, bylaws, rules and regulations of that union, for its final and binding determination. The parties failed to make explicit provision as to how net losses should be distributed, and when a dispute arose over that matter Graham filed a lawsuit. The musicians and their representatives responded with a petition to compel arbitration, the trial court ordered arbitration before the International Executive Board, and that tribunal, after hearing by

a referee which it appointed, ultimately awarded $53,000 against Graham. That award was confirmed by a superior court as an arbitration award, and Graham appealed.

The Supreme Court first determined that the contracts involved were, in light of all the circumstances, contracts of adhesion, *i.e.*, "a standardized contract, which, imposed and drafted by the party of superior bargaining strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it. [Citation]." (*Id.*, at p. 817.) While Graham was a successful and prominent promoter, he was "required by the realities of his business as a concert promoter to sign A.F. of M. form contracts with *any* concert artist with whom he wished to do business," and the fact that he may have possessed considerable bargaining strength with respect to other provisions of the contracts did not remove the taint of adhesion from the provisions complained of. (*Id.*, at pp. 818-819.)

The court went on to observe that, while the adhesive character of a contract will not itself preclude enforcement, "there are two judicially imposed limitations on the enforcement of adhesion contracts or provisions thereof. The first is that such a contract or provision which does not fall within the reasonable expectations of the weaker or 'adhering' party will not be enforced against him. [Citations; fn. omitted.] The second — a principle of equity applicable to all contracts generally — is that a contract or provision, even if consistent with the reasonable expectations of the parties, will be denied enforcement if, considered in its context, it is unduly oppressive or 'unconscionable.' [Citations]." (*Id.*, at p. 820.)

Finally, the court concluded that the contractual provision requiring arbitration of disputes before the A.F. of M, while not contrary to the reasonable expectations of the parties, was nevertheless unconscionable, and therefore unenforce-

able "because it designates an arbitrator who, by reason of its status and identity, is presumptively biased in favor of one party." (*Id.*, at p. 821.) Though the California Arbitration Act does not strictly preclude parties from designating a non-neutral arbitrator "when . . . the contract designating such an arbitrator is the product of circumstances suggestive of adhesion, the possibility of overreaching by the dominant party looms large; contracts concluded in such circumstances, then, must be scrutinized with particular care to insure that the party of lesser bargaining power, in agreeing thereto, is not left in a position depriving him of any realistic and fair opportunity to prevail in a dispute under its terms." (*Id.*, at pp. 824-825.) Thus, "certain 'minimum levels of integrity' [must] be achieved if the arrangement in question is to pass judicial muster." (*Id.*, at p. 825.) And the court held, "an arrangement which designates the union of one of the parties as the arbitrator of disputes arising out of employment — especially when, as here, the arrangement is the product of circumstances indicative of adhesion" fails to meet that standard. (*Id.*, at p. 827.)

APPLICATION OF *SCISSOR-TAIL*.

Here, as in *Scissor-Tail*, the contract containing the arbitration provision was adhesive in nature. It consisted of a standard employment application form, prepared by the New York Stock Exchange, and imposed by Shearson upon all applicants for employment. Shearson does not claim that petitioners had any options other than "to adhere to the contract or reject it." (28 Cal.3d at p. 817.) Petitioners' bargaining strength in relation to Shearson was patently less than was Graham's in relation to the musicians and their representatives.

We must also conclude on the basis of the standards set forth in *Scissor-Tail* that the arbitration provisions contained

in the contract were unconscionable, and therefore unenforceable. Whether or not those provisions were contrary to the reasonsable expectations of the parties is an issue we cannot determine on this record; but here, as in *Scissor-Tail*, the arbitral body is so associated with a party to the contract, i.e., Shearson, as to be presumptively biased in favor of that party.

The board of directors of the New York Stock Exchange consists of twenty directors elected by members of the Exchange and a chairman of the board elected by the board. Ten of the directors are required to be representatives of the public, none of whom are, or are affiliated with, brokers or dealers in securities; the remaining ten must be members or allied members of the Exchange bearing specified relationship to member corporations or firms. The constitution provides for "allied members" and this category of membership can include a principal executive officer of a member corporation, or a person who controls such a corporation, but it does not include employees in the category of petitioners, and even "allied members" do not vote for the board of directors.

The New York Stock Exchange, and thus its board of directors, performs a variety of quasi-public functions; but insofar as the board of directors functions in disputes between members firms and their employees, it is presumptively biased in favor of management in the same way that the Supreme Court deemed the International Executive Board of the A.F. of M. to be presumptively biased in favor of member musicians. This is not to say that members of the board of directors are in fact biased, or that they would necessarily exercise their authority in a consciously biased fashion; it is to say that the structure of governance of the Exchange is such that there exists a presumptive *institutional* bias in favor of member firms and members who constitute

the electoral constituency of the board. Petitioners, being outside that constituency (cf. Gear v. Webster (1968) 258 Cal.App.2d 57; Graham v. Scissor-Tail, Inc., supra, 28 Cal.3d 807, 822) have legitimate cause to complain.

It does not serve adequately to distinguish *Scissor-Tail* that the arbitration tribunal in that case was the governing board of the union while here it is not the board itself but a panel of arbitrators appointed by the chairman with the approval of the board. The presumption of bias does not disappear simply because the decisional power is delegated. Nor is the presumption dispelled by rules requiring the arbitrators to be persons not engaged in the securities business, or giving the non-member one peremptory challenge, or granting the director of arbitration authority to disqualify an arbitrator. Evenhandedness could be assured by a procedure which permits selection of arbitrators by the parties to the dispute or, failing that, through the auspices of some truly neutral party. In the absence of such a procedure we must conclude, as in *Scissor-Tail*, that the arbitration procedures of the New York Stock Exchange fail to meet minimal levels of integrity.

In *Scissor-Tail* the court remanded with instructions that the trial court should afford the parties a reasonable opportunity to agree on a suitable arbitrator and, failing such agreement, the court itself should on petition of either party appoint the arbitrator. (28 Cal.3d at p. 831.) Neither party requests such a procedure here. Moreover, arbitration of the tort issues would be somewhat complicated by the non-arbitrable nature of related issues based upon petitioners' claim for commissions due. We consider that justice would be better served in this case by allowing petitioners to proceed with their action in court.

Accordingly, a peremptory writ will issue requiring the respondent court to vacate its order of July 10, 1979, grant-

ing the petition of real parties in interest for an order to arbitrate the dispute therein pursuant to the rules of the New York Stock Exchange, and to enter an order denying said petition.

CERTIFIED FOR PUBLICATION

Grodin, J.

WE CONCUR:

Elkington, Acting P.J.

Newsom, J.

Attorneys for Petitioners: George M. Kraw, Esq., Trepel & Clark, 99 Almaden Boulevard, Union Bank Bldg., Suite 850, San Jose, CA 95113.

Attorneys for Real Parties in Interest: Michael M. Gless, Esq., Keesal, Young & Logan, Pier F - Berth 203, P. O. Box 1730, Long Beach, CA 90801.

Received July 31, 1981.

Exhibit "6"

Letter From the Clerk of the California Supreme Court Notifying All Parties That the Petition for Hearing Had Been Denied.

[Letterhead the Supreme Court of California]

October 14, 1981

Mr. John W. Clark
Trepel & Clark
850 Union Bank Building
99 Almaden Boulevard
San Jose, California 95113

Ms. Lana Borsook
Milbank, Tweed, Hadley, & McCloy
1 Chase Manhattan Plaza
New York, N.Y. 10005

Mr. Frank J. Wilson
National Association of
Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

Re: 1 Civ 47841 — Hope v. Superior Court (Santa Clara)

Dear Counsel:

The court on October 14, 1981 denied the petition for hearing in the above matter (no votes to grant). No order

was made regarding the amicus curiae briefs or untimely answer and they are therefore returned.

Very truly yours,

Laurence P. Gill,
Clerk of the Supreme Court

/s/ J.L. Kavanagh
By: J.L. Kavanagh
Chief Deputy

JLK:kr
Enclosures
cc: Keesal, Young & Logan
Received, Oct. 19, 1981

Opposition

Office - Supreme Court, U.S.
FILED
FEB 4 1982
ALEXANDER L. STEVAS,
CLERK

No. 81-1295

In the Supreme Court of the United States

OCTOBER TERM, 1981

SHEARSON HAYDEN STONE, INC., J. BARRY GRAY,
Petitioners,

vs.

ROBERT W. HOPE, K. JAMES POND,
Respondents,

SUPERIOR COURT OF THE COUNTY OF SANTA CLARA,
Respondent.

Brief in Opposition to Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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No. 81-1295

In the Supreme Court of the United States

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SHEARSON HAYDEN STONE, INC., J. BARRY GRAY,
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ROBERT W. HOPE, K. JAMES POND,
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SUPERIOR COURT OF THE COUNTY OF SANTA CLARA,
Respondent.

Brief in Opposition to Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

1. THIS COURT IS NOT REQUIRED TO APPLY FEDERAL SUBSTANTIVE LAW TO DETERMINE THE VALIDITY OF THE RE-1 AGREEMENT.

In its first argument in support of its Petition for Certiorari, Shearson Hayden Stone, Inc. ("Shearson") asserts that the

> "RE-1 Agreement, in creating an employment relationship which involves and affects interstate commerce, must be enforced pursuant to applicable federal substantive law." (Petition, 9)

Shearson failed to raise that argument in the trial court, in the Court of Appeal, in the California Supreme Court on Hope and Pond's petition for hearing, or indeed, in the Court of Appeal upon remand by the California Supreme Court for reconsideration. In fact, until it lost, Shearson consistently relied on California arbitration statutes, and *Lewsadder v. Mitchum, Jones & Templeton, Inc.*, 36 Cal. App.3d 255, 111 Cal.Rptr. 405 (1973) in support of its position that, under California law, disputes between employees of brokerage firms and the firms must be arbitrated. The Court of Appeal decided the case based on Shearson's motion to stay proceedings and compel arbitration under California law, California Code of Civil Procedure §§ 1281.2, 1281.4 (Appendix, 7).

Shearson never raised the issue of the application of federal substantive law until after the Court of Appeal published its decision. Even if federal substantive law applies, Shearson waived its application.

Shearson's analysis of "federal substantive law" begs the question. There is no evidence in the record that the employment relationship "involves and affects interstate commerce". In *Main v. Merrill Lynch, Pierce, Fenner & Smith*, 67 Cal.App.3d 19, 24, 136 Cal.Rptr. 378 (1977), plaintiff *conceded* that her transaction with a brokerage firm of which she was a customer, not an employee, was a transaction involving interstate commerce.

Here, Shearson sought arbitration pursuant to the California Code of Civil Procedure, never contended that the employment relationship created a relationship involving or affecting interstate commerce, and until its last Petition to the California Supreme Court, never sought an interpretation of the RE-1 Agreement pursuant to federal substantive law.

Although this case has been briefed many times, Shearson did not raise its legal argument until now. In a similar situation, citing with approval *Ernst v. Searle,* 218 Cal. 233, 22 P.2d 715 (1933), a California court recently held:

> "Although the case was thoroughly briefed in the trial court, plaintiff did not raise the doctrine of equitable tolling, hence the trial court had no opportunity to determine whether or not it was applicable. It is settled that a party may not raise a new theory for the first time on appeal . . . because to permit him to do so would not only be unfair to the trial court but manifestly unjust to the opposing litigant. [citation omitted]" *Sierra Club, Inc. v. California Coastal Commission,* 95 Cal.App.3d 495, 503, 157 Cal.Rptr. 190 (1979)

Even if one were to reach the merits of the question, the answer is that the employment relationship created by the agreement does not involve or affect interstate commerce. The questions raised in the lawsuit arise out of the termination of employment in California and the events and discussion surrounding that termination, as well as allegations of unfair competition by the employer against the employees. The only "interstate" aspect of the case is that a company doing business nationally may be held liable for damages to two California residents.

Finally, the California Supreme Court dealt with the issue in the case which was dispositive of this case, and that legal analysis should be applicable here. *Graham v. Scissor-Tail, Inc.,* 28 Cal.3d 807, 828-831, 171 Cal.Rptr. 604 (1981).

2. THE STATE COURT IS NOT PREEMPTED FROM RULING THAT THE ARBITRATION PROCEDURES HEREIN ARE INVALID.

Shearson launches a constitutional and statutory attack on the jurisdiction of the State courts to resolve this dis-

pute. (Petition, 12) At least Shearson acknowledges that a similar argument was advanced in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware,* 414 U.S. 117, 38 L.Ed. 2d 348, 94 S.Ct. 383 (1973) where the claim was rejected. Shearson nevertheless argues that actions of lower courts and administrative agencies have led to a *de facto* reversal of that decision.

This Court concluded that the policy arguments advanced by Merrill Lynch do not require preemption of contrary state law because there was nothing which specified arbitration as the favored means of resolving employer-employee disputes. Moreover, the relationship between employer-employee arbitration, on the one hand, and fair dealing and investor protection on the other, is for all practical purposes non-existent. Also, this Court observed that the purported need for national uniformity in the area of wage claims is not vital to Federal securities policy:

> "Indeed, Congress, in the securities field, has not adopted a regulation system wholly apart from and exclusive of state regulation." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, supra,* at 134-136.

Shearson's preemption argument is directly contrary to established case authority and should be rejected.

CONCLUSION

Shearson's Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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Amicus Brief

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FEB - 5 1982

No. 81—1295

IN THE
Supreme Court of the United States
October Term, 1981

SHEARSON HAYDEN STONE, INC.,
J. BARRY GRAY,
Petitioners,

—against—

ROBERT W. HOPE, K. JAMES POND,
Respondents,

SUPERIOR COURT OF THE COUNTY OF SANTA CLARA,
Respondent.

On Petition for Writ of Certiorari to the Court of Appeal of the State of California First Appellate District Division One

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF AMICUS CURIAE OF NEW YORK STOCK EXCHANGE, INC. AND AMERICAN STOCK EXCHANGE, INC.

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In The

Supreme Court of the United States

October Term, 1981

Shearson Hayden Stone, Inc.,
J. Barry Gray,
Petitioners,

—against—

Robert W. Hope, K. James Pond,
Respondents,

Superior Court of The County of Santa Clara,
Respondent.

On Petition for Writ of Certiorari to the
Court of Appeal of the State of California
First Appellate District
Division One

MOTION OF NEW YORK STOCK EXCHANGE, INC. AND AMERICAN STOCK EXCHANGE, INC. FOR LEAVE TO FILE BRIEF AMICUS CURIAE

New York Stock Exchange, Inc. ("NYSE") and American Stock Exchange, Inc. ("AMEX") (together the "Exchanges") move pursuant to Rule 42 of the rules of this Court for leave to file the annexed brief *amicus curiae* in support of the position of petitioner, Shearson Hayden Stone, Inc., that its petition for a writ of certiorari should be granted and the decision of the court below should be reversed because the court below is pre-empted from applying state common law to the arbitration procedure

of the Exchanges, a vital component of the regulatory scheme created by the Securities Exchange Act of 1934 (the "Exchange Act"). It is further submitted that the court below erred in interpreting the Exchanges' constitutions and rules with respect to arbitration.

NYSE and AMEX are, and have been since October 1, 1934 and September 1, 1934, respectively, registered with the Securities and Exchange Commission ("SEC") as national securities exchanges pursuant to § 6 of the Exchange Act. NYSE and AMEX are the nation's largest and second largest securities exchanges.

The Exchange Act provides a comprehensive regulatory scheme under which private self-regulatory organizations function under the supervision of the SEC. The Exchange Act was extensively amended in 1975 to strengthen governmental oversight of such organizations.

Prior to the amendments, this Court in *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Ware,* 414 U.S. 117 (1973) had determined that the authority delegated under the Exchange Act did not pre-empt state law with respect to compulsory arbitration before NYSE of disputes between member firms and their employees. However, this Court has not reviewed the issue since the 1975 amendments to the Exchange Act.

Resolution of this issue now bears directly on preserving the integrity of the Congressionally-mandated regulatory scheme, in determining the extent to which regulation will remain with the organization and supervisory agency to which it was delegated. This case also affords the Court the opportunity to resolve conflicting decisions among state and lower federal courts concerning the fairness of the Exchanges' arbitration rules.

The Exchanges have been unable to obtain the consent of all the parties to the filing of a brief *amicus curiae* and

therefore request the Court's leave to file the attached brief *amicus curiae.*

Dated: February 4, 1982

Respectfully submitted,

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In The

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On Petition for Writ of Certiorari to the Court of Appeal of the State of California First Appellate District Division One

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BRIEF AMICUS CURIAE OF NEW YORK STOCK EXCHANGE, INC. AND AMERICAN STOCK EXCHANGE, INC.

INTEREST OF NEW YORK STOCK EXCHANGE, INC. AND AMERICAN STOCK EXCHANGE, INC.

New York Stock Exchange, Inc. ("NYSE") and American Stock Exchange, Inc. ("AMEX") (together the "Exchanges") are national securities exchanges registered with the Securities and Exchange Commission ("SEC") pursuant to § 6 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a—78hh-1, 78kk (the "Exchange Act"). NYSE and AMEX are New York not-for-profit corporations. NYSE has 1,366 members, most of whom are associated with one of the NYSE's 564 member organizations. AMEX has 889 members (regular, option principal and associate members) associated with its 449 member organizations. As self-regulatory organizations under the Exchange Act,

NYSE and AMEX are charged with supervisory and enforcement responsibilities over their members and member organizations, including their approximately 55,000 registered persons, 6,000 AMEX registered options principals, and 130,000 other employees. In carrying out their supervisory and enforcement responsibilities, NYSE and AMEX collectively monitor over 89 per cent of all exchange-traded securities transactions in the United States, and AMEX monitors 32 per cent of all options trading in the United States.

In ruling that former employees of a member firm of the Exchanges could not, as a matter of California law, be compelled to arbitrate their claims against that firm, the court below, without the benefit of any submission from the Exchanges, held that the "procedures for arbitration prescribed by the constitution and rules of the New York Stock Exchange are so one-sided, as applied to employer-employee disputes, as to render the agreement [to arbitrate] unenforceable." The court below described the NYSE arbitral body as "presumptively biased" in favor of the member firm and NYSE arbitration procedures as failing to meet "minimal levels of integrity." AMEX arbitration rules and procedures are virtually identical to those of NYSE.

Hundreds of the Exchanges' arbitrations which invoke these procedures criticized by the court below are pending throughout the country. The decision of the court below jeopardizes the successful resolution of these controversies.

Moreover, the decision of the court below has the potential of severely undermining the carefully honed regulatory scheme of the Exchange Act, furthered by the Exchanges' arbitration systems. The Exchanges have a vital interest, if not obligation, in seeing their rules preserved.

SUMMARY OF ARGUMENT

The court below erroneously applied state common law to invalidate the rules of the Exchanges promulgated in furtherance of a duty of self-regulation imposed by the Exchange Act and subject to supervision of the SEC. This highly-regulated scheme for the securities industry pre-empts the state court from so ruling.

The application for approval of the Exchanges of a registered representative's employment, which binds the applicant to compulsory arbitration of employment disputes, is required by the Exchanges of both employer and employee pursuant to its self-regulatory obligations and cannot, therefore, be deemed to constitute a contract of adhesion under state common law. The Exchanges' constitutional provisions and rules governing selection of arbitrators and the operations of the Exchanges' arbitration systems are clearly not so lacking in fairness as to render a contract invoking them unconscionable and unenforceable and have been approved by the SEC under its delegation from Congress such that application of state common law to invalidate them is pre-empted.

ARGUMENT

The Securities Exchange Act Scheme of Exchange Self-Regulation Pre-Empts Application of State Common Law to Invalidate Exchange Rules

The Exchange Act created an extensive duty of self-regulation by national securities exchanges coupled with oversight by the SEC. *Gordon* v. *New York Stock Exchange, Inc.*, 422 U.S. 659, 667 (1975); *Silver* v. *New York Stock Exchange*, 373 U.S. 341, 352 (1963). National securities exchanges must register with the SEC, and registration may not be granted unless the SEC determines that an exchange's rules are designed to promote just and equitable principles of trade, and, in general to protect investors and the public interest. § 6, 15 U.S.C. § 78f. Exchanges must file proposed rules and proposed rule changes with the SEC, which proposals cannot take effect unless approved by the SEC. § 19(b), 15 U.S.C. § 78s(b). The SEC may abrogate, add to, and delete from the rules of an exchange as the SEC deems "necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this chapter and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of this chapter . . . ." § 19(c), 15 U.S.C. § 78s(c).

"One aspect of the statutorily imposed duty of self-regulation is the obligation to formulate rules governing the conduct of exchange members." *Silver* v. *New York Exchange*, 373 U.S. at 353. Specifically, NYSE Rule 347, requiring controversies between registered representatives and members arising out of the employment or termination of employment of the registered representative to be settled by arbitration, falls within this duty. *Drayer* v. *Krasner*, 572 F.2d 348, 358 (2d Cir.), *cert. denied*, 436 U.S. 948 (1978); *Rust* v. *Drexel Firestone, Inc.*, 352 F. Supp. 715, 718 (S.D.N.Y. 1972).

> The Exchange, in its self-regulatory role has a legitimate interest in deciding how disputes between its members and their employees are to be resolved;

> it has a legitimate interest in fostering harmonious relations among the varied groups whose daily activities play a role in the complex operations of the Exchange. Considering that interest, it is not unreasonable to require those engaged in such operations to resolve their disputes, which oft-times may center about practices peculiar to the Exchange, through prompt and economic arbitration rather than by drawn out litigation before judges of fact who may be without experience in the trade practices and customs.

Rust v. *Drexel Firestone, Inc.*, 352 F. Supp. at 718 (footnote omitted).

This Court's decision in *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Ware*, 414 U.S. 117 (1973) does not dictate a contrary result. Applying the principles delineated in *Silver* v. *New York Stock Exchange*, this Court had determined in *Ware* that NYSE Rule 347(b) (equivalent to current NYSE Rule 347) did not fall within the Exchanges' mandate of § 6(b) to protect the investing public (and thereby requiring pre-emption of contrary state law) because under the Exchange Act as then enacted, the rule was not subject to the SEC's review which had been circumscribed by certain subject matter limitations explicitly enumerated in § 19(b). 414 U.S. at 135 and n.14.

Subsequent to the Court's decision in *Ware*, the Exchange Act was significantly amended, in part, to strengthen the SEC's oversight role with respect to self-regulatory organizations. S. Rep. No. 94-75, 94th Cong., 1st Sess. 22, *reprinted in* 1975 U.S. Code Cong. & Ad. News 200. Judge Friendly addressed the precise question of whether after *Ware* and in light of the Exchange Act amendments, NYSE Rule 347 constituted an exercise of "congressionally delegated authority for self-regulation in the national interest." 414 U.S. at 134. He held that it did:

> Whatever the relationship of this rule to the objective of investor protection, it is germane to the

goal of market efficiency, reflected in § 6(b) and throughout the 1975 amendments, see, e.g., §§ 2; 11A(a)(1)(C); 15A(b)(6); (9); 17A(a)(1); 19(f); 23(a)(2), and to the objective of fair administration of the Exchange, implicated in § 6(b) and an explicit standard of § 19(c). Registered representatives play an important role in the flow of business on securities exchanges. The arbitration provision enables member firms to rid themselves of registered representatives who, as they believe, are dishonest or ineffective, or who have violated rules of the NYSE, . . . without subjecting themselves to lengthy and costly litigation . . . . It is likewise in the interest of fair administration and market efficiency, as well as in he public interest, that honest and ethical registered representatives should have speedy, cheap and effective remedies against their employers. At least, the NYSE is entitled to think this in the absence of any indication otherwise from the SEC.

Unlike the situation that the Court found so troublesome in *Ware,* there are now several avenues for SEC involvement. Section 31(b) of the 1975 Amendments directed the Commission to notify by June 4, 1976, any exchange whose rules were not in compliance with applicable requirements of the Act. Compliance was required within 180 days thereafter or the exchange would face sanctions or abrogation of the offending rules. Further, the reports on the bill specifically charged the Commission with an obligation "to remove existing burdens on competition and to refrain from imposing, or permitting to be imposed, any new regulatory burden 'not necessary or appropriate in furtherance of the purposes' of the Exchange Act." H.Rep. No. 94-229, 94th Cong., 1st Sess. 94 (1975); S.Rep. No. 94-75, supra at 13, U.S. Code Cong. & Admin. News 1975, pp. 321, 325. The SEC review of exchange rules has not implicated

> Rule 347. See Release No. 34-12157 (Mar. 2, 1976); Release No. 34-13027 (Dec. 1, 1976); Release No. 14002 (Sept. 27, 1977). Nor has the Commission sought in any way to exercise its power under § 19(c) to alter the NYSE arbitration provisions.

Drayer v. *Krasner*, 572 F.2d at 358.

Thus NYSE Rule 347 is a regulatory provision which squarely furthers the policy of the Exchange Act and which must therefore be given pre-emptive effect. *See Coenen* v. *R.W. Pressprich & Co.*, 453 F.2d 1209, 1214 (2d Cir.), *cert. denied*, 406 U.S. 949 (1972); *Axelrod & Co.* v. *Kordich, Victor & Neufeld*, 451 F.2d 838 (2d Cir. 1971); *Dickstein* v. *duPont*, 443 F.2d 783 (1st Cir. 1971).

The written Form No. RE-1 Applications for Approval of Employment (the "Agreements"), which the court below held were contracts of adhesion and unenforceable because they were unconscionable under state law, implement this statutory regulatory scheme and NYSE Rule 347 in particular. The Exchanges are charged with enforcing compliance by their members and "persons associated with . . . [their] members" (defined to include employees of members, § 3c, 15 U.S.C. § 78c(a)(21)) with the provisions of the Exchange Act, the rules and regulations thereunder and their own rules. § 19(g), 15 U.S.C. § 78s(g)(1)(A). So the Exchanges provide the Agreements to the member firm/employer and the prospective registered representative/employee alike (signed by both employer and employee) in furtherance of their statutory obligation of self-regulation.

Each registered representative must register with and be acceptable to the Exchanges. NYSE Rule 345(a)(1); AMEX Rule 341. In consideration of the Exchanges' consideration of each prospective registered representative's application, the applicant must sign an agreement which includes a pledge that the registered representative will abide by the constitution and rules of the Exchanges.

NYSE Rule 345, Supplementary Material .16; AMEX Rule 341, Commentary .08.

Respondents' Agreements contain just such pledges. They provide in paragraph 30(d):

> I have read the Constitution and Rules of the Board of Governors of the New York Stock Exchange, Inc. and, if approved, I hereby pledge myself to abide by the Constitution and Rules of the Board of Governors of the New York Stock Exchange, Inc. as the same have been or shall be from time to time amended, and by all the rules and regulations adopted pursuant to the Constitution, and by all practices of the Exchange.

Respondents thereby agreed to abide by NYSE Rule 347 which provides that:

> Any controversy between a registered representative and any member or member organization arising out of the employment or termination of employment of such registered representative by and with such member or member organization shall be settled by arbitration, at the instance of any such party, in accordance with the arbitration procedure prescribed elsewhere in these rules.

Moreover, respondents specifically agreed to submit to NYSE arbitration. In paragraph 31(j) the Agreements, tracking NYSE Rule 347, provide:

> I agree that any controversy between me and any member or member organization or affiliate or subsidiary thereof arising out of my employment or the termination of my employment shall be settled by arbitration at the instance of any such party in accordance with the arbitration procedure prescribed in the Constitution and rules then obtaining of the New York Stock Exchange, Inc.

Paragraph 30(10) of the AMEX employment agreements is virtually identical and provides further that if the em-

ployer is a member organization of NYSE, the dispute shall be settled by arbitration in accordance with the NYSE constitution and rules.

Numerous courts throughout the country have enforced such agreements (many construing the identical Form No. RE-1) and compelled the registered representative to arbitrate a dispute arising out of employment with a member firm/former employer. *E.g.*, *Drayer* v. *Krasner*, 572 F.2d 348; *Dickstein* v. *duPont*, 443 F.2d 783; *Katz* v. *Shearson Hayden Stone, Inc.*, 438 F. Supp. 637, 641 (S.D.N.Y. 1977); *Rust* v. *Drexel Firestone, Inc.*, 352 F. Supp. 715; *Youmans* v. *District Court*, 197 Colo. 28, 589 P.2d 487 (1979); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *District Court*, 190 Colo. 239, 545 P.2d 1035 (1976); *Moritz* v. *Francis I. duPont & Co.*, 291 Minn. 523, 189 N.W.2d 487 (1971); *Crawford* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 35 N.Y.2d 291, 319 N.E.2d 408, 361 N.Y.S.2d 140 (1974). Contrary to the court below, other courts have ruled that the Agreements simply are not contracts of adhesion. In *Rust* v. *Drexel Firestone, Inc.*, Judge Weinfeld held that an employment agreement containing the same paragraph 31(j) of the Agreements was not a contract of adhesion:

> The contract was one of employment, the essence of which centered about compensation, commission and other prerequisites. There is no suggestion that these were not bargained for at arms length between plaintiff and defendant. This aspect of their negotiations was not on a "take it or leave it basis." The defendant was neither a monopolist nor a public utility. Plaintiff, if dissatisfied with the compensation offered or other conditions pertaining to his work, was free to seek employment with another investment banker. Although it is true that he would still be required to accept the arbitration clause, such a provision was relatively of minor significance as against the terms of compensation and commission. It is also significant to note that rather than being viewed as oppressive, arbitration clauses are favored by both state and

> federal law as an economical form of dispute resolution which relieves the congestion of overburdened courts. Moreover, the arbitration provision was not imposed unilaterally by the defendant upon the plaintiff; it was imposed upon both by the Constitution and Rules of the Exchange; the defendant, no less than the plaintiff, gave up its right to a judicial forum.

352 F. Supp. at 717 (footnote omitted); *accord*, *Katz* v. *Shearson Hayden Stone, Inc.*, 438 F. Supp. at 641; *Brown* v. *Gilligan, Will & Co.*, 287 F. Supp. 766, 774 (S.D.N.Y. 1968); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *District Court*, 190 Colo. at 242, 545 P.2d at 1037 (registered representative "chose to make his living in a highly regulated industry. One consequence of that choice is that he agree [sic] to be bound by the rules and regulations governing that profession."); *White-Weld & Co.* v. *Mosser*, 587 S.W.2d 485, 487 (Civ. App. Tex. 1979), *cert. denied*, 446 U.S. 966 (1980).

The court below was also precluded from ruling that the arbitration provision in the Agreements was unconscionable under state law because "the arbitral body is so associated with a party to the contract, i.e. Shearson, as to be presumptively biased in favor of that party." The Exchange Act requires that members be assured a fair representation in the selection of exchange directors and that at least one director not be associated with a member, broker or dealer. § 6b, 15 U.S.C. § 78f(b)(3). The NYSE's members elect 20 directors, ten representatives of the public, unaffiliated with brokers or dealers, and ten members or allied members. The Board of Directors elects a Chairman. NYSE Constitution, Art. II. The AMEX members similarly elect a Board of Governors equally divided between representatives of the public and members, which Board also elects a Chairman. AMEX Constitution, Art. II, § 1.

The Exchanges' Chairmen each appoint two panels of arbitrators, one composed of persons engaged in the secu-

rities business and one composed of persons not engaged in the securities business. NYSE Constitution, Art. VIII, § 4; AMEX Rule 601. Respondents' claims would be heard by five arbitrators, the majority of whom would be persons not engaged in the securities business. NYSE Constitution, Art. VIII, § 6.

Despite describing this balanced composition of member and public directors (acknowledged by the House of Representatives conferees during the passage of the 1975 amendments to the Exchange Act (H. R. Rep. No. 94-229, 94th Cong., 1st Sess. 98, *reprinted in* 1975 U.S. Code Cong. & Ad. News 329)) and securities and non-securities affiliated arbitrators, the court below inexplicably concluded that "the structure of governance of the Exchange is such that there exists a presumptive *institutional* bias in favor of member firms and members who constitute the electoral constituency of the board." NYSE arbitration is not biased because the court below says it is.

Apparently the court below preferred selection of arbitrators by the parties to the dispute or through the auspices of some "truly neutral party." But the court's conclusion that the arbitration procedures of NYSE "fail to meet minimal levels of integrity" flies in the face of the Exchanges' statutory duty of self-regulation, supervised and approved by the SEC. The court cannot substitute its notions of arbitration procedure for the system sanctioned by the SEC under its delegation from Congress.

The registered representative in *Drayer* challenged the composition of the NYSE arbitration tribunal because its selection departed from the two widely accepted methods for choosing arbitrators cited by the court below. In ruling that the NYSE's compulsory arbitration procedure for disputes between registered representatives and members was not so far beyond the area of permissible self-regulation as to be unreasonable and in violation of the antitrust law, Judge Friendly wrote:

> We do not think that, absent evidence of actual unfairness in the operation of the NYSE arbitra-

> tion tribunals, . . . their composition is so improper as to invalidate the program under the anti-trust laws. The mere fact that the three members not engaged in the securities business are drawn from a panel appointed by the Chairman of NYSE does not reflect upon their fairness in a dispute between a member and a registered representative; the arduous and generally thankless task of acting as an arbitrator represents rendition of a service rather than receipt of a perquisite. Such difficulty as exists comes from the required presence of a member of NYSE and another person "engaged in the securities business," [the current rules provide for two persons engaged in the securities business] who, of course, could be a registered representative but apparently rarely is. The Special Study, *supra* [2 Report of Special Study of Securities Markets 559-61 (1963)] noted the composition of the arbitration tribunal in controversies between members and nonmembers without objection. It also noted that for the years 1957-1961, the claimant had prevailed in 53 cases and had lost in 69.[13] Registered representatives have a trade association, the Association of Investment Brokers, see *Jacobi* [v. *Bache & Co.*], *supra*, 520 F.2d at 1235; presumably the Association would have complained to the SEC if it believed the arbitration procedure was working unfairly.

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[13] Five of these decisions were in disputes between members, allied members, and member organizations. Aside from these cases, most claimants were nonmembers. Special Study, *supra* at 560. Focusing on the record for the years 1960-61, the Commission noted the impartiality of both the arbitration director and the arbitrators. *Id.* at 561.

572 F.2d at 359. *Accord, Youmans* v. *District Court*, 197 Colo. at 31, 589 P.2d at 489-90 (rejecting argument of "possible partiality of the arbitration panel").

CONCLUSION

The petition of Shearson Hayden Stone, Inc. should be granted, the order of the court below reversed and the Exchanges' arbitration procedure and rules, an integral part of the regulatory scheme of the Exchange Act, preserved.

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Respectfully submitted,

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